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Indiana Law Journal

Volume 43 | Issue 2 Article 4

Winter 1968

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THE PUBLIC POLICY LIMITATION ON DEDUCTIONS FROM GROSS INCOME: A CONCEPTUAL ANALYSIS

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It is commonplace that items which would be deductible under the usual rules for computing taxable income will be denied deduction if their allowance is deemed to frustrate a clearly defined public policy.[1] There is, however, a curious lack of clarity as to the rationale and scope of this doctrine. Although there are many decisions of lower courts on the subject, the pronouncements of the Supreme Court are few and somewhat ambivalent.[2] Moreover, although there have been proposals for clarifying legislation in the past,[3] only one facet of the doctrine has been codified thus far[4] and it seems unlikely that further congressional action will occur in the near future. Finally, little of the extensive literature has been concerned with a conceptual view of the subject.[5]

What is needed is a framework for critical appraisal of the doctrine. In an attempt to provide such a framework this discussion will be oriented toward five basic ideas: the net income concept, the roles of punishment and subsidy, the idea of federalism, the requirements of good administration, the proper exercise of rule-making power. However, before proceeding to a description and discussion of these five points of

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1. For the history and current status of the public policy doctrine see Diamond, *The Relevance (or Irrelevance) of Public Policy in Disallowance of Income Tax Deductions,* 44 TAXES 803 (Dec. 1966); Lindsay, *Tax Deductions and Public Policy,* 41 TAXES 711 (1963); Paul, *Use of Public Policy by the Commissioner in Disallowing Deductions,* 1954 So. CAL. TAX INST. 715.

2. Commissioner v. Tellier, 383 U.S. 687 (1966); Cammarano v. United States, 358 U.S. 498 (1959); Hoover Express Co. v. United States, 356 U.S. 38 (1958); Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958); Commissioner v. Sullivan, 356 U.S. 27 (1958); Lilly v. Commissioner, 343 U.S. 90 (1952); Commissioner v. Heininger, 320 U.S. 467 (1943); Textile Mills Corp. v. Commissioner, 314 U.S. 326 (1941).

3. S. 3650, 89th Cong., 2d Sess. (1966); S. 2479, 89th Cong., 1st Sess. (1965); H.R. 7394, 86th Cong., 1st Sess. (1963); S. 2356, 86th Cong., 1st Sess. (1963).

4. INT. REV. CODE of 1954, § 162(c). It is also possible to consider sections 162(d) and 152(5) as codifications of other aspects of the doctrine. The former disallows net losses from gambling; the latter prevents the taxpayer from claiming as a dependent one with whom he resides if their relationship is contrary to local law. It has been suggested that section 165(d) should be expanded to deny deduction of all gambling losses so that gamblers would be taxed on their gross income. Baker, *Taxation: Potential Destroyer of Crime,* 29 CHI.-KENT L. REV. 197 (1951). *See also* SPECIAL COMM. TO INVESTIGATE ORGANIZED CRIME IN INTERSTATE COMMERCE, 81ST CONG., THIRD INTERIM REPORT vv-vb (1951). However, H.R. 7394, 86th Cong., 1st Sess. (1963), and S. 2356, 89th Cong., 1st Sess. (1965) which incorporated this proposal did not become law.

5. *But see* Comment, *Business Expenses, Disallowance and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code,* 72 YALE L.J. 108 (1962).

orientation and their relevance to the public policy doctrine, some comments of a more general nature are necessary.

It is, of course, obvious that the income tax has frequently been employed to implement policy judgments other than those related to revenue gathering, fiscal management, or achieving more equitable income distribution—the ends most frequently mentioned as the fitting goals of taxation.[6] These non-revenue oriented uses of the income tax are commonly considered to be either bad on their merits, responsible for the increasing volume and complexity of the law, or both.[7] Words such as "loophole," "special interest," or "erosion" are the pejoratives frequently employed in discussions of such provisions of the law and, although their separate or collective evils are evaluated by most disinterested commentators with varying degrees of alarm, defenders are almost exclusively from the ranks of their sponsors or beneficiaries.[8] In a sense the public policy doctrine with which this article is concerned could be numbered among these other non-revenue oriented provisions. However, a distinction can be drawn between it and them on the ground that the doctrine considered here is designed to, or has the effect of, discouraging particular kinds of conduct by making more burdensome the cost of engaging in them whereas the great bulk of the other special provisions supports the taxpayers or activities to which they apply. Thus, they tend to diminish the tax base. The public policy doctrine, on the other hand, has the contrary effect.[9] Another distinction may be found in the fact that most special provisions are the creations of the Congress whereas the public policy doctrine is, thus far, almost completely the creature of the courts and the Internal Revenue Service.

For these reasons it appears reasonable to consider the public policy limitation on deductions as something apart from the usual non-revenue oriented provision of law or, indeed, as more nearly the analog of the gambler's stamp tax[10] or the excise taxes on wagers[11] or filled cheese.[12] For these same reasons, in a discussion of the public policy

6. *See* Heller, *Some Observations on the Role and Reform of the Federal Income Tax,* HOUSE COMMITTEE ON WAYS AND MEANS TAX REVISION COMPENDIUM 181 (1959).

7. *See* Blum, *Federal Income Tax Reform—Twenty Questions,* 41 TAXES 672 (1963); *cf.* Sneed, *The Criteria of Federal Income Tax Policy,* 17 STAN. L. REV. 567, 603 (1965).

8. *See* Baker & Griswold, *Percentage Depletion—a Correspondence,* 64 HARV. L. REV. 361 (1951). *See also* Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted,* 70 HARV. L. REV. 1145 (1957) and Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws,* 68 HARV. L. REV. 745 (1955).

9. *See* Comment, *supra* note 5, at 115.

10. INT. REV. CODE of 1954, § 4411.

11. *Id.* § 4401.

12. *Id.* § 4841.

doctrine, one need not necessarily become embroiled in the construction of a comprehensive tax base,[13] although one's predisposition toward the proper solution of this broader problem will lend color to one's view of this issue. Finally, note should be made that, although primary emphasis here will be upon the cases arising under section 162,[14] there are other areas to which the public policy doctrine relates, as for example, section 165[15] or section 501[16] as it involves the status of organizations which engage in racial discrimination.[17]

THE "NET INCOME" CONCEPT

"We start with the proposition that the federal income tax is a tax on net income. . . ."[18] The effect of the denial of a deduction for an expense incurred by the taxpayer in the course of generating includable income is pro tanto to levy the tax on "gross" rather than "net" income. Although there appears no constitutional limitation on the power of Congress to levy a tax on gross income,[19] it is clear that Congress has acted otherwise. In the area of business income particularly, Congress has, by permitting the deduction of expenses incurred in business,[20] limited the exercise of its taxing power to the net yield of the business

13. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967), points out the difficulties with the concept of a "comprehensive tax base" so thoroughly that one might have thought the subject would take a considerable time to recover from the analysis. This is not the case, however. *See* Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967) and Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967).

14. INT. REV. CODE OF 1954, § 162(a) provides as follows:

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. . . .

15. INT. REV. CODE OF 1954, § 165(a) provides as follows:

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

16. INT. REV. CODE OF 1954, § 501 lists approximately eighteen different classes of organization which are exempt from taxation.

17. The Internal Revenue Service has recently considered the significance of racial discrimination by charitable and educational organizations to their status under § 501(c)(3). Rev. Rul. 67-325, 1967 INT. REV. BULL. No. 40, at 7, and IRS News Release, 7 CCH 1967 STAND. FED. TAX REP. ¶ 6734, at 71, 789.

18. Commissioner v. Tellier, 383 U.S. 687, 691 (1966).

19. *See* Note, *Taxability of Gross Income Under the Sixteenth Amendment*, 36 COLUM. L. REV. 274 (1936).

20. INT. REV. CODE of 1954, § 162.

operation. The primary issues raised in this regard have, therefore, related to the nexus between the expense and the business and to the distinction between expense and capital investment.[21]

In dealing with the "nexus" and "capital" issues, one can take either a liberal or a restrictive position. The restrictive approach has familiarly been founded on the idea that deductions are a matter of legislative grace.[22] From this idea it is said to follow that the language of a deduction provision should be construed narrowly—that is, against the taxpayer. On the other hand, it has been argued that the language used by Congress in writing deductions has no special status and should, therefore, be construed in the same manner as any other statutory language.[23] It is evident that one who begins from the restrictive approach to deductions is more apt to find a justification for denying a deduction because of frustration of public policy than is one who does not.

Even if, on balance, a restrictive reading of section 162 is not, as a general proposition, defensible either in logic or authority, this does not necessarily mean that the language of section 162, fairly construed, clearly prevents a denial of a deduction because of a reliance on the public policy doctrine in all cases. One could look to the Supreme Court for support in this view.[24] Moreover, the role of the doctrine was called to the attention of the Congress at the time it last dealt with the problem of illegal expenses; from this, support for the doctrine based on the reenactment argument may be derived.[25] However, it must also be conceded that both the Court and Congress have exhibited a fair degree of ambivalence. One need only compare the Court's opinion on *Commissioner v. Sullivan*[26] with its opinion in *Tank Truck Rentals v. Commissioner*[27] or the congressional rejection of a tax on the gross income of gamblers[28] with the enactment of section 162(c)[29] to illustrate the

21. These issues arise from the use of the phrase "ordinary and necessary" in section 162. The term "necessary" is said to require that an expense be "appropriate and helpful" in carrying on taxpayer's business. The term "ordinary" is used to distinguish expenses from capital expenditures which are not deductible under section 262.

22. Deputy v. DuPont, 308 U.S. 488, 493 (1940).

23. Note, *An Argument against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace,* 56 HARV. L. REV. 1142 (1943).

24. *See, e.g.,* Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).

25. INT. REV. CODE of 1954, § 162(c), enacted as part of the Technical Amendments Act of 1958, 72 Stat. 1608 (1958). *See also* Letter from Commissioner Harrington to Senator Williams, March 11, 1957, 103 CONG. REC. 12418 (1957); S. REP. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 937.

26. 356 U.S. 27 (1958).

27. 356 U.S. 30 (1958). The decisions in the *Tank Truck Rental* and *Sullivan* cases were announced on the same day. It has been suggested that the Supreme Court attempted to "accommodate" the net income concept and the public policy doctrine in these opinions. Lindsay, *supra,* note 1, at 718. The "accommodation" is an uneasy one.

28. INT. REV. CODE OF 1954, § 162(c); also see note 4 *supra.*

29. INT. REV. CODE OF 1954, § 162(c); also see note 25 *supra.*

proposition. One can, of course, minimize the apparent inconsistencies by pointing out that *Tank Truck Rentals*[30] involved a fine levied by a state to punish the violator of its law whereas *Sullivan* was engaged in an illegal business, but his expenses were for rent and wages[31] or by pointing out that a tax on the gross income of gamblers[32] is far removed from denying only one kind of expense deduction to an otherwise presumably legal enterprise.[33] But even so, there remains an unresolved polarity between the concept of a tax on the net income of a business and the doctrine that some non-capital costs of producing business income are to be denied deduction because of the manner in which the business is conducted or because of the source of its receipts.

One familiar situation in which there appears to be a well established departure from the net income concept should be noted before we leave this subject. This involves the expenses of a hobby which are not deductible because they are not incurred in trade or business or for the production of income.[34] This rule would presumably oblige the inclusion of the gross receipts of the hobby but disallow an offset of the costs incurred in generating those receipts. However, the Treasury by a Regulation[35] has eliminated the requirement of including all such receipts in the case of the hobby farm where the expenses are in excess of the income therefrom. At the same time it denies the deduction of a net loss from such activity.[36] Accordingly, in effect, the exclusion-of-crime rule has accomplished a result in keeping with the net income concept although the deductions are disallowed.

It is, therefore, a fair generalization that the net income concept is, with the exception of the public policy doctrine, ubiquitous in the law of federal income taxation.

THE ROLES OF PUNISHMENT AND SUBSIDY

"[T]he federal income tax is . . . not a sanction against wrongdoing."[37]

The polarity mentioned above is reflected in the dichotomy often found in characterizations of the result of allowance or denial of a

30. 356 U.S. 30 (1958).
31. 356 U.S. 27 (1958).
32. INT. REV. CODE OF 1954, § 162(c); see also note 4 *supra*.
33. Commissioner v. Sullivan, 356 U.S. 27 (1958).
34. INT. REV. CODE of 1954, §§ 162, 212. *See* Ellsworth v. Commissioner, 31 P-H TAX CT. MEM. 170 (1962).
35. Treas. Reg. § 1.162-12 (1958).
36. INT. REV. CODE of 1954, §§ 165(c)(1), (2). *See* Treas. Reg. § 1.165-6(a)(3) (1960). There is no corresponding provision of the Regulations as to section 212, however.
37. Commissioner v. Tellier, 383 U.S. 687, 691 (1966).

deduction. One view regards the allowance of a deduction for an expense incurred in an illegal setting as a subsidy of the illegal conduct. An opposing view looks upon the denial of a deduction as a punishment visited upon the taxpayer because of his conduct. Obviously, to one who regards the tax as properly levied on net income only, the punishment characterization of a disallowance of deduction comes easily. Conversely, the notion of subsidy follows easily if one regards deductions as a matter of grace to be allowed grudgingly.

If the subsidy characterization is adopted, it will be argued next that the subsidy increases in value in proportion to the income level of the wrongdoer as a result of the progressive rate structure.[38] Sometimes this discrepancy is intended to justify disallowance as a self-evident sequitur and presumably, evoke sympathy for the poorer miscreant. Reference to the progressive structure, when one begins from the punishment view, produces a similar distortion—the rich are punished more heavily than the poor even though the nature of the misconduct may be the same in the case of each.

An argument based on the effect of progression does not carry either side very far, however, for the progressive rate structure is intended to work a disparity between rich and poor. Hence, to refer to that particular effect of the denial of deduction is merely to illustrate the operation of a basic principle of federal income taxation. It would be as relevant to point out that the rich wrongdoer bears a greater burden on his illegal receipts than does the poor.

On a more sophisticated level, the relevance of the punishment-subsidy argument may be pursued in relation to the notion of "neutrality" in taxation. The starting point here is the value judgment that "good" tax law will not effect the burdens of carrying on one kind of income producing activity more heavily than it does another. The commitment may be taken as valid on its own terms even though the tax law that "is" can hardly be said to approach closely the criterion. A step in the right direction may, however, be valued highly.

The difficulty with the "neutrality" argument as applied to the public policy doctrine resides in the fact that the doctrine has little effect on the way taxpayers plan their affairs. That is to say, it can have little deterrent effect on a decision to do wrong. For example, one cannot imagine that the decision of the managers of Tank Trust Rentals Inc. to carry over-loads on the highways of Pennsylvania was effected pro or con by their prediction as to the outcome of the case which ultimately went to the Supreme Court. First, they need not have contemplated an

38. *See* Lindsay, *supra* note 1, at 720.

audit. Second, even if an audit took place, the item might not have provoked inquiry. Third, the state of the law was such that a revenue agent might have passed it in any event. Fourth, even if it was predicted that the deduction would be disallowed, could the managers have done otherwise as a matter of sound judgment—where the costs of complying with the weight ceiling were probably prohibitive?

This last point, one guesses, is controlling in most public policy cases. The tax involved is comparatively small in comparison to the economic gain which is expected to result from the particular activity or payment.[39] The forseeable application of the doctrine in most cases will not deter. It is not likely either that its non-application will give significant encouragement to wrongful conduct. Thus, whether it applies or not is of no importance in how taxpayers plan their affairs.

So viewed, the punishment-subsidy controversy amounts to very little—whichever way one characterizes the effect of allowance and disallowance. However, on grounds to be discussed below, the issue retains a certain vitality, not with respect to particular taxpayers or even as to patterns of conduct, but rather in reference to politics and government.

The Idea of Federalism

"We think the suggestion has never been made—certainly never entertained by this Court—that the United States may impose cumulative penalties above and beyond those imposed by state law for infractions of the state's criminal code by its own citizens."[40] Irrespective of the attrition which has taken place in the vitality of the tenth amendment, one area of traditional state autonomy remains comparatively unimpinged —the area of law enforcement as to intra-state crime.[41] Thus, in cases where the public policy doctrine involves activities illegal under state law, the concept of federalism is properly added to the criteria of appraisal.

If the allowance of a deduction arising from an expense incurred in activity contrary to state law is characterized as a subsidy of such activity, the federal government surely places itself in an anomalous

39. A notable exception might have been found in the treble damage claims paid in the so-called Philadelphia Electric cases of 1960 where more than 1800 suits were brought against electrical manufacturers as a result of criminal proceedings instituted by the United States under the Sherman Antitrust Act. General Electric Company alone paid about 200 million dollars to private claimants. However, the Treasury ruled that the punitive element of the damage payments was deductible. Rev. Rul. 64-224, 1964-2 Cum. Bull. 52. *See also* Comment, *supra* note 5, at 120 and 124.

40. United States v. Constantine, 296 U.S. 287, 296 (1935).

41. "Crime is largely a local problem. It must be attacked primarily at the local level . . . The conduct of various forms of gambling enterprises . . . are all violations of local law. The public must insist upon local and state law enforcement agencies meeting the challenge. . . ." Third Interim Report, *supra* note 4, at 3. *See also* White J. *concurring in* Murphy v. Waterfront Commission, 78 U.S. 52, 96 (1964).

position vis-à-vis a friendly sovereign. If, on the other hand, disallowance is viewed as a penalty on the activity, an equally troublesome anomaly results; without regard to the sufficiency of the primary sanction imposed by the state, a secondary punishment is imposed on acts not declared wrongful by the United States.[42] Thus, the subsidy characterization tends to permit a rationale not inconsistent with the relation between state and federal authority within the federal system, whereas the punishment characterization leads to a conflict within the relationship in the sense that the federal government intrudes (albeit with supportive intent) in an area of law enforcement supposedly reserved to the states.

Beyond the argument which looks to the punishment-subsidy antinomy lie other considerations, for the impact of the doctrine on state policy is apt to be ad hoc. First, before the doctrine can become operative, the taxpayer's return must be selected for audit. Audit selection criteria are developed with reference to support of the self-reporting system and to revenue yield. Neither of these criteria is relevant to state law enforcement. That is, the considerations which stimulate state law enforcement authorities to the discovery, apprehension, and prosecution of wrongdoers bear no relation to the selection of those who may be subjected to the weight of the tax detriment. One might argue further than unless the doctrine's application is limited to cases of taxpayers actually prosecuted and convicted of state crimes, denial of deduction on public policy grounds may reflect a distortion of the real policy of the state manifested in the unwillingness or inability of the prosecuting authorities to have taken action. On the other hand, so to limit the application of the doctrine would necessarily raise problems attributable to the differing time schedules of income tax audits and state criminal procedures for a final determination of guilt by the state courts may not take place until long after the year of a payment which is subject to disallowance under the doctrine.

The significance of federalism to the discussion would be vastly changed if a rationale for the public policy doctrine could be found in an interest of the United States referable to some area of concern which is within its competence under the Constitution. By hypothesis, regulation of interstate commerce does not provide this rationale and it is clear that a desire for national uniformity in the application of the tax law is hindered rather than served by the doctrine.

Section 162(c) would appear to present a paradigm case for the discernment of such a rationale since there the disallowed payments are not necessarily contrary to the policy of the sovereign in whose territory

42. *See* Comment, *supra* note 5, at 126.

they are made.[43] Accordingly, the only place where the importance of the denial of deduction could be found would be among the interests of the United States itself. Unfortunately, however, it is difficult to pin-point this interest. Such motivation for the enactment of section 162(c) as appears of record accepts, as a starting place, the doctrine as applied to domestic payments.[44] Off the record, the suggestion has been made that section 162(c) was aimed at discouraging the support by United States business of a certain particularly unpleasant dictatorial regime.

Section 162(c) does, however, suggest a line of argument which is related to the issue of federalism. Since citizens of the United States are also citizens of the state in which they reside, it may be argued that the United States has a reasonable interest in their conduct with respect to the laws of the states and in discouraging violation of those laws. Moreover, in most cases where the public policy doctrine operates to prevent frustration of state policy, there can be found a federal policy analogous to that of the state. Thus, there is an atmosphere supportive of the doctrine which tends to blunt any criticism which is based on the idea of federalism.

But despite this coloration, one must ultimately accept the notion that the United States possesses a power to discourage or punish offenses against another sovereign in order to answer the challenge of federalism to the operation of the doctrine where state law is involved. The source of this power remains obscure.[45]

THE REQUIREMENTS OF GOOD ADMINISTRATION

The difficulties for the Internal Revenue Service which the doctrine

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43. INT. REV. CODE of 1954, § 162(c), enacted as part of the Technical Amendments Act of 1958, 72 Stat. 1608 (1958). *See also* Letter from Commissioner Harrington to Senator Williams, March 11, 1957, 103 CONG. REC. 12418 (1957); S. REP. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 CUM. BULL. 937. It is clear that Congress regarded the enactment of § 162(c) as "necessary" *because* the payments were not contrary to the law of the country in which they were made.

44. *See* S. REP. No. 1983, 85th Cong., 2nd Sess. 937 (1958) which, in referring to cases where bribes paid to foreign officials are not contrary to the foreign country's law, says:

> [i]n such cases the Service has indicated that because legal recourse is not available to the taxpayer in the operation of his business, it would find it difficult to sustain the position that the expenses in such a case were not ordinary and necessary to the taxpayer's business.

No explanation of why such payments are disallowed deduction where the taxpayer nominally *has* the right to sue the person to whom he has paid them is to be found in the Report.

45. One suggestion would refer to "a general common law." Cahn, *Local Law In Federal Taxation*, 52 YALE L. J. 799, 820 (1943). Another possibility is to take a broad view of the federal police power. *See* Cushman, *Social and Economic Control Through Federal Taxation*, 18 MINN. L. REV. 759 (1934). Historically one can trace the use of the public policy doctrine to an English case where, of course, federalism is of no concern. Inland Revenue Commissioner v. Warnes & Co. (1919), 2 K.B. 444.

presents are obvious. The occasions on which violations of state or federal law may trigger disallowance of deductions are many and various. To enumerate but a few examples, there might be fines for violation of regulations under state antitrust laws,[46] penalties for infraction of federal liquor regulations,[47] penalties assessed for violation of the Federal Safety Appliance Act,[48] fines for violations of a state minimum price law,[49] payments made in violation of state commercial bribery statutes[50] or kickback payments by an insurance broker to his customers in violation of state laws,[51] kickbacks in violation of the Federal Trade Commission Act,[52] bribery of public officials,[53] or damage payments for fraudulent dealings with governmental authority.[54] From even this partial list it becomes apparent that a good part of the entire body of criminal and regulatory law of local, state, and federal government may in one way or another come before the Service in the form of a claimed deduction. This fact leads to a second point: the necessity for the audit personnel to identify and evaluate the claimed deduction in terms of such laws and to judge properly in each case (a) whether the law reflects a "clearly defined" public policy[55] which (b) would be "frustrated" by the allowance of the deduction.[56] The judgment that revenue agents are

46. Columbus Bread Co., 4 B.T.A. 1126 (1926).
47. Helvering v. Superior Wines & Liquors, 134 F.2d 373 (8th Cir. 1943).
48. Tunnel R.R. of St. Louis v. Commissioner, 61 F.2d 166 (8th Cir. 1932).
49. Atzingen-Whitehouse Dairy, Inc., 36 T.C. 173 (1961).
50. Dixie Machine Welding & Metal Works, Inc. v. United States, 315 F.2d 439 (5th Cir. 1963).
51. Boyle, Flagg & Seaman, Inc., 25 T.C. 43 (1955).
52. Rev. Rul. 54-27, 1954-1 CUM. BULL. 44.
53. T.G. Nicholson, 38 B.T.A. 190 (1938).
54. David R. Faulk, 26 T.C. 948 (1956).
55. It is generally stated that in order for a public policy to provide an effective basis for the operation of the doctrine it must be a policy which is defined through some governmental declaration. Lilly v. Commissioner, 343 U.S. 90 (1952). However, whether the mere declaration in itself is or should be enough raises perplexing problems. For example, in Boyle, Flagg & Seaman, Inc., 25 T.C. 43 (1955), although the insurance laws of Illinois made it clear that the kickback of a portion of his commission by an insurance broker to his customer was illegal, the only sanction imposed on the taxpayer by the state Commissioner of Insurance was a reprimand. If the pattern of enforcement activity by the state authority is properly to be considered in determining the existence of state policy—that is, as part of its "declaration"—in this instance the clarity of the declaration was somewhat blurred. *Cf.* Allen Schiffman, 47 T.C. 537 (1967), where the agent collected the premium net of the rebate from his customer and then himself sent the full premium to the company, thereby avoiding the deduction problem altogether.
56. The question could be resolved quite easily if the governmental declaration of policy included a statement of the deductibility *vel non* of payments associated with the regulated or prohibited transaction or behavior. In the case of federal law, the declaration could be directly effective on the question [*e.g.*, Defense Production Act of 1950, 50 App. U.S.C. 2062 (1964)]; in the case of state law, a statement of hope or expectation, although not sufficient in itself, would considerably simplify the revenue agent's task and would presumably be honored. *See* Comment, *supra* note 5, at 123. *See also*

fitted to the performance of these tasks presumably must be based on the assumed existence of a training and talent which is not required in terms of their hiring or provided them by their experience within the Service.

Beyond these problems there exists a less obvious and more speculative significance of the doctrine for tax administration. This relates to the investigative latitude within which the Service now operates and the effect on that latitude of Service involvement in the collateral areas of law which were mentioned above. The Service has enjoyed a greater tolerance as to the scope of its investigations and as to the depth of information which it is entitled to demand from both taxpayers and third parties than is afforded to other law enforcement agencies.[57] This fact may be explained by the recognized importance of the revenue gathering function or by the necessarily broad categories of persons and transactions which performance of this function legitimately encompasses. In part, at least, this tolerance also must be attributed to the confidence in which the data gleaned by the Service is held.

If one considers three factors which relate to this last point, the issue becomes clear. First, information gathered by the Service is made available to other parts of the federal establishment on executive order, and to certain committees of Congress by statute.[58] Second, this information may also be made available to state tax officials.[59] Third, this information is made dramatically more accessible than was formerly the case through the increasing use of new retrieval machinery and techniques.[60] Expressions of concern have already been raised from diverse sources as to the peril to traditional protections afforded the citizen which is raised by these factors.[61] The involvement of the Service in violations of laws not relating to revenue[62] may well exacerbate these feelings of

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Note, *Deductibility of Penalty Payments as Business Expenses*, 59 YALE L. J. 561, 568 (1950).

57. *See* Miller, *Administrative Agency Intelligence Gathering: An Appraisal of the Investigative Powers of the Internal Revenue Service*, 6 B.C. IND. & COM. L. REV. 657, 664 (1965).

58. INT. REV. CODE OF 1954, §§ 6103(a), (d).

59. *Id.* § 6103(b). In addition, forty-one states have entered into agreements with the federal government for the exchange of information relating to tax administration.

60. Miller, *supra* note 57, at 666.

61. V. PACKARD, THE NAKED SOCIETY, 42 (1964); E. WILSON, THE COLD WAR AND THE INCOME TAX: A PROTEST (1963).

62. The idea of the employment of federal tax administration in the so-called "war on organized crime" has enjoyed considerable attention. *See* THIRD INTERIM REPORT, *supra* note 4, at 303 reporting that the Service

> states that it has to the best of its ability considering its limited manpower, begun investigating these returns. It states further that where it pursues the case of one of these individuals, it prefers to set up against him a case of criminal tax evasion which is a felony, rather than the lesser offense of failing to keep proper books and records, which is a misdemeanor.

The Report recommended that the Service set up a list of known gamblers "whose

alarm with the result that such involvement may in the long run tend to prejudice the Service's freedom to pursue its primary mission with anything like the latitude it now enjoys.[63]

THE PROPER EXERCISE OF RULE-MAKING POWER

It is apparent that by far the greatest development of the public policy doctrine has taken place in judicial and administrative rule-making and that Congress has assumed a comparatively minor role. But the thrust of the cases has by and large been directed toward defining the extent of the doctrine, while little attention has been paid to its genesis. It would appear, however, that the doctrine must find its justification in the interpretative function of the courts and the Treasury. Such a function in the tax law sometimes relates to the explanation and elaboration of particular statutory language—for example, the word "gift" as used in section 102[64] or the phrase "convenience of the employer" as used in section 119.[65] It may also relate, however, to broader statutory policy not necessarily attached to a particular word or phrase, but rather associated with an entire area of the law—such as the development of the case-law concept of "continuity of interest"[66] in the field of corporate reorganization or the line of cases having to do with assignment of income.[67]

It is possible to distinguish between these two kinds of interpretative roles. The narrower more traditional role which concerns itself with words and phrases usually is necessitated by the inability of a legislative body to speak with precision to all possible cases through the use of general language. The *broader role*—more usually associated with the function of the courts in dealing with a constitution than with their

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income tax returns must be given special attention." *Id.* at 9-10. Compare, however, the criticism of the Service's performance in this regard in ORGANIZED CRIME AND LAW ENFORCEMENT 302-3 (Ploscowe ed., 1951). Compare also the criticism of the Service's involvement in such matters found in Justice Black's dissent in Rutkin v. United States, 343 U.S. 130, 139 (1952).

63. An example of the deterioration of administrative standards which can take place where revenue gathering is made the instrument of criminal law enforcement can be found in the experience with the ten percent excise tax on wages and the fifty dollar occupational stamp tax on gamblers, INT. REV. CODE of 1954, §§ 4401, 4411. See the Appendix to this article.

64. INT. REV. CODE of 1954, § 102 excludes from gross income amounts received as gifts and through legacy, devise, or inheritance.

65. INT. REV. CODE of 1954, § 119 excludes from gross income the value of food and lodging provided by an employer to his employee under certain circumstances. One of the requirements for exclusion is that the provision have been made for the "convenience of the employer."

66. *See* LeTulle v. Scofield, 308 U.S. 415 (1940) and Pinellas Ice and Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). Also see Treas. Reg. § 1.368-1(b) (1955).

67. *See* Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 11 (1930).

function in regard to statutes—*has uniformly been assumed in tax law in order to prevent tax avoidance.*

To the extent this distinction is meaningful, it is of interest to note that the public policy doctrine got its start through the exercise of the narrower function. Specifically, the Commissioner and the courts concerned themselves with the meaning of the phrase "ordinary and necessary" and concluded that Congress cannot have considered it "necessary," for example, that a businessman bribe a public official or commit a criminal act which occasions imposition of a fine.[68] In *Commissioner v. Tellier,*[69] however, the Supreme Court so narrowly defined the phrase "ordinary and necessary" that there was no room left in the phrase for elaboration sufficient to support the public policy doctrine.[70] Thus, although there was no concern with tax avoidance, there was a broadly gauged interpretative effort detached from specific statutory language—an effort without a unifying principle to shape its direction. It may be a sense of this difficulty which led the Court in *Tellier* to confine application of the doctrine to "extremely limited circumstances."[71]

It may be objected that the "frustration of public policy" concept offers as much to a unifying principle of interpretation as does "tax avoidance." However, it should be observed that the orientation of "tax avoidance" is toward the income tax statute itself and that interpretative principles such as "continuity of interest" are aimed at preserving the integrity of the taxing system which the statute establishes. There is, therefore, in such cases an internal point of reference for the judge or administrator. On the other hand, the orientation of the "frustration" concept is outside the statute and, therefore, the rules to which the concept gives rise are directed outward toward issues of social control well beyond the usual concerns of a revenue statute.

A further objection to this analysis may be raised by pointing to the numerous examples where the Congress itself has enacted provisions the prime concerns of which are not with revenue but rather with other, more remote, issues—for example, the stimulation of scientific research.[72] There are a number of differences, however, between such actions by

68. Sarah Backer, 1 B.T.A. 214 (1924).
69. 383 U.S. 687 (1966).
70. Our decisions have consistently construed the term 'necessary' as imposing only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business.' The principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures. . . .

Commissioner v. Tellier, 383 U.S. 687, 69 (1966) (Citations omitted).
71. *Id.* at 683-84.
72. *See* INT. REV. CODE of 1954, §§ 117, 174.

the Congress and the analogous interpretative activity of the courts and the Commissioner in the public policy area. First, the enumerated powers of the Congress extend far beyond matters of revenue. Thus, the range of proper congressional concern and activity is very broad indeed. Second, the range of congressional choice of the form in which these enumerated powers may be exercised is also quite broad. For example, in the exercise of the power to regulate commerce among the states, Congress may choose to employ the taxing power as the form of regulation. Third, there are certain problems with which legislatures can deal more effectively than courts or administrators, if only because of the fact-gathering capacity of legislative bodies. Therefore, one cannot properly support an exercise of the interpretative function by a court or an administrator by pointing to an analogous exercise of congressional power.

It might appear, accordingly, that a public policy limitation on deductions is more properly the responsibility of Congress than of the courts or administrators. Reference to a recent legislative proposal will, however, indicate that resolution of the difficulties already discussed cannot be looked for in Congress with any degree of optimism.

In 1966, Senator Russell Long introduced legislation[73] which incorporated substantially the recommendations of the Staff of the Joint Committee on Internal Revenue Taxation[74] contained in a study undertaken as a result of the Revenue Ruling which permitted the deduction of treble damage payments in antitrust cases.[75] The bill provided for the disallowance of three types of payments: fines and penalties paid to any government for the violation of law,[76] antitrust treble damages payments,[77] and bribes or kickbacks paid to public officials or private parties.[78] As to bribes and kickbacks paid to private parties, however, the bill's effect would be limited to cases where the taxpayer had been convicted of having made such payments.[79] In all cases except treble damage payments, the act would apply only as to amounts paid after the date of enactment.[80] As to treble damage payments, it would apply only to violations of the antitrust laws occurring after the enactment date.[81]

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73. S. 3650, 89th Cong., 2d Sess. (1966).
74. STAFF OF JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, STUDY OF INCOME TAX TREATMENT OF TREBLE DAMAGE PAYMENTS UNDER THE ANTITRUST LAWS (1965).
75. Rev. Rul. 64-224, 1964-2 CUM. BULL. 52.
76. S. 3650, 89th Cong., 2d Sess. § (f) (1966).
77. *Id.* § (g).
78. *Id.* § (c) (2).
79. *Id.*
80. *Id.* § (b).
81. *Id.*

It is apparent from even this brief description that the proposal does not mention all aspects of the public policy doctrine, for example, to name the principal omissions, the expenses of the illegal business, payment of which are not in themselves illegal,[82] and forfeitures.[83] Nor is it clear on the face of the bill whether it is intended to be exclusive in the area or whether, on the other hand, case law is to fill in the gaps.

Even in its limited form, the proposal raises problems. For example, the provision denying deduction of bribes and kickbacks to public officials does not define the interdicted payments. It does not distinguish a bribe from a gift or from entertainment.[84] And should it deny deduction of gifts to an entertainment of public officials without reference to the standards of section 274?[85] To take another example, how would its provision which denies deduction of illegal payments to private individuals operate? The denial according to the language of the proposal can take place only after conviction of the taxpayer. This may not take place until years after the year of payment. Because of this, the bill provides for a special extension of the statute of limitations, but the extension applies only where the indictment or information was returned or filed prior to the expiration of the usual period of limitations on tax deficency assessments. The net effect of the conviction requirement and the limitations provision might well be to increase the number of such payments which will gain deduction rather than to decrease them—a result far

82. There is some confusion as to the deductibility *vel non* of expenses which would raise no question if they were not made in pursuance of an illegal enterprise, such as the medical supply costs of an abortionist, Estate of Karger v. Commissioner, 13 CCH TAX CT. MEM. 661 (1954). This issue was further clouded by the opinion of the Supreme Court in Commissioner v. Sullivan, 356 U.S. 27 (1958), where amounts paid as rent and wages by a gambler whose activities were illegal under state law were held deductible principally on the net income view of the tax. However, the state statute made the employment and rental themselves illegal acts. The Court obviously did not rest its decision on this fact but can be viewed instead as having decided the case in favor of the taxpayer in spite of it.

83. For example, the taxpayer was denied deduction of the loss of his investment in slot machines which were confiscated by state authorities in Hopka v. United States, 195 F. Supp. 474 (N.D. Iowa 1961).

84. *See* Dukehart-Hughes Tractor & Equipment Co. v. United States, 341 F.2d 613 (Ct. Cl. 1965); *compare* Raymond F. Flanagan, 47 B.T.A. 782 (1942).

85. INT. REV. CODE of 1954, § 274 establishes rules limiting the deduction of expenses for business entertainment and gifts. These rules apply only to amounts otherwise allowable under the test of section 162. On the other hand there is implicit in section 274 the recognition that entertainment and gifts in the commercial setting do not always amount to bribery or kickbacks. Treas. Reg. § 1.274-2(c)(5) (1963) gives as one example of an expenditure which is considered directly related to the "active conduct" of a trade or business a payment made "directly or indirectly by the taxpayer for the benefit of an individual (other than an employee), . . . if such expenditure was in the nature of compensation for services. . . ." If the recipient of the payment is the purchasing agent of the taxpayer's customer the ambiguity is apparent. Also see the example given in Treas. Reg. § 1.274-2(f)(i)(c) (1963).

from the intention of the draftsmen and the sponsor.[86]

CONCLUSION

Two propositions emerge from the foregoing; first, it is difficult to justify the public policy limitation on deductions as created by the courts and the Treasury. Second, there is little likelihood of satisfactory legislation.

As to the first of these conclusions, it may be that the decision of the Supreme Court in the *Tellier* case[87] will have the effect of compelling a retreat from the doctrine's outer boundaries. It is difficult to report that this is indeed the case as yet, however. The Tax Court, for example, after the decision in *Tellier*, upheld application of the doctrine in a case involving a payment in violation of the New York commerical bribery statute.[88] Neither has there been any public statement of a change in Service policy, although it would seem in its interest that the Court's message be heeded.

On its merits, even if Congress were to codify the doctrine and the question of congressional power is conceded, at the very least one can doubt the wisdom of applying the doctrine to payments arising out of state law violations; even as to matters of federal law, the weight of the net income concept is hard to rebut.

And so the doctrine rests. The next decision by the Supreme Court on the subject could sound its death-knell.[89] The current interest in the treatment of antitrust damages, on the other hand, might spur a congressional response in terms of a broadened legislative foundation.[90] Absent these actions, the Service (with or without public announcement) could well alter its audit practice by failing to raise the issue hereafter. Or, finally, matters can continue as they are: a rule of uncertain content, dubious validity, and questionable wisdom continuing to be administered

86. S. 3650, 89th Cong., 2d Sess. (1966), was introduced in response to the Commissioner's ruling which allows the deduction of treble damage payments in antitrust losses. *See* note 36 *supra*. It is clear from the circumstances and the bill's text that there was no intention to constrict the public policy doctrine; rather, the intention was to the contrary.

87. 383 U.S. 687 (1966).

88. Coed Records, Inc., 47 T.C. 422 (1967). The opinion contains no reference to the *Tellier* case. For that reason it is of little value.

89. In its opinion in the *Tellier* case the Supreme Court may be said to have restricted application of the doctrine to the cases encompassed by Treas. Reg. § 1.162-20(b) (1965) (lobbying and campaign expenses) and to payments of fines and penalties. As to fines and penalties, it adhered to its holding in Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 38 (1958). But how one squares this limited endorsement of the doctrine with the rationale of its opinion in the *Tellier* case itself is less than apparent.

90. However, S. 3650, 89th Cong., 2d Sess. (1966), was not enacted nor has it been reintroduced.

in a hit-or-miss fashion—largely, one suspects, because its burden falls in most cases on those without "the temerity to litigate."[91] It is legitimate to question whether such a rule meets those minimal standards which entitle it to be considered a rule of law at all.[92] In any case such a rule cannot be considered "good" law.[93]

APPENDIX

AN ILLUSTRATION OF THE EFFECT ON TAX ADMINISTRATION OF THE USE OF THE INTERNAL REVENUE SERVICE IN THE ENFORCEMENT OF CRIMINAL LAW

The police department of a large city conducted a raid on a local gambling establishment early in 1965. The taxpayer was among those arrested and had in his possession at the time of his arrest betting slips which indicated his involvement in a numbers operation. Pursuant to its practice, the police department sent its arrest list to the local office of the Intelligence Division (Regional Commissioner of Internal Revenue). This Division, in turn, sent the taxpayer's name to the Collection Division of the District Director's Office. An agent of the Collection Division conducted an oral interview with the taxpayer, after which a wagering tax deficiency of about 10,000 dollars plus interest and penalties of 4,000 dollars was assessed. This assessment was based essentially upon the product of multiplying the amount of the betting slips found upon taxpayer's person at the time of his arrest by the number of weeks he was assumed to have been engaged in this activity, *i.e.* the years 1958 through 1964. Upon the taxpayer's failure to pay the amount claimed, liens against taxpayer's back account, real estate, and other property were filed and collection procedures begun.[94] No opportunity for adminis-

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91. In United States v. Sullivan, 274 U.S. 259, 264 (1927), a case upholding the requirement of filing a return as to the owner of an illegal business, Mr. Justice Holmes said:

> [i]t is urged that if a return were made the defendant would be entitled to deduct illegal expenses, such as bribery. This by no means follows, but it will be time enough to consider the question where a taxpayer has the temerity to raise it.

In cases where there is the possibility of characterizing the transfer as a business gift or as entertainment it is unlikely that a taxpayer would deliberately choose to use the more blatant designation. In a case where there is no such possibility one suspects the transfer will not be claimed or, if claimed, will be cloaked in some catch-all caption, such as "commissions." In the latter case, however, it is doubtful that the taxpayer will reveal the identity of the payee if he is pressed to do so on audit; thus, the deduction will be disallowed for want of substantiation.

92. *See* Fuller, *Positivism and Fidelity to Law—A Reply to Professor Hart*, 71 HARV. L. REV. 630 (1958).

93. *See* Sneed, *The Rule of Good Law and Federal Taxation*, 2 B.C. IND. & COM. L. REV. 203 (1961).

94. These facts are within the personal knowledge of the author or are believed to be legimately inferrable from facts within his knowledge.

trative hearing prior to assessment was offered the taxpayer.

Among the issues presented by the facts described above is the propriety of the Internal Revenue Service's conduct. Revenue Procedure 57-26[95] was promulgated by the Commissioner for the express purpose of bringing pre-assessment procedures in excise tax cases into conformity with the pre-assessment procedures employed by the Commissioner in income, estate, and gift tax cases (with one exception not material for our purpose).[96] But, in this case, these procedures were not followed and it is understood by the writer that they are generally disregarded by the Service in cases involving the tax on wagers.[97] The possible justification in law for this conduct by the Commissioner will be discussed below. Before turning to an analysis of this aspect of the matter, attention must be given to the characterization of the excise tax on wagers as involving the use of the Service in the enforcement of criminal alw.

It must be conceded at this point in time that, whatever the merits, there can be no successful claim of invalidity of the tax based on an alleged improper use of the taxing power or upon the tenth amendment.[98] This is not to say, however, that it is unfair or improper to characterize the enactment of the tax as primarily motivated by the desire to strike at organized gambling activity. The evidence tends to support this view, particularly when its history is read together with that of the stamp tax on the occupation of gambling. For example, Congressman Cooper is quoted in the debates on enactment as follows: "[W]e might indulge the hope that the imposition of this type of tax would eliminate that kind of activity."[99] Again, although the yield estimate for both taxes was placed at only 400,000,000 dollars annually the then Commissioner disagreed with this as vastly overstated,[100] and the subsequent history has proved the ineffectiveness of the taxes as revenue-producers. Indeed,

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95. 1957-2 CUM. BULL. 1093.

96. Review may not be had in the Appellate Division of the Regional Commissioner's office, as it may be in agreed income, estate, and gift tax cases. Instead, the taxpayer is granted review by analogous procedures in the District Director's office.

97. This understanding is based on informal conversations with various persons, both in and out of the Service. *See also* Hockman & Tack, *Jeopardy Assessments—A System in Jeopardy*, 45 TAXES 418, 429 (1967).

98. United States v. Kahriger, 345 U.S. 22 (1953). *See also* Cushman, *The National Police Power Under the Taxing Clause of the Constitution*, 4 MINN. L. REV. 247 (1920) and Note, *The Constitutionality of Federal Taxation as an Exercise of Federal Police Power*, 28 N.D. LAW. 127 (1952). United States v. Costello and United States v. Marchetti, 352 F.2d 848 (2d Cir. 1965), *cert. granted*, 383 U.S. 942 (1967) are now *sub judice*; however, consideration by the Supreme Court is limited to the Fifth Amendment aspects of the wagering tax. Hence, the Court's decision is not likely to touch upon the matters raised by the text.

99. 97 CONG. REC. 6892 (1951).

100. *See* Chenoweth, *A Judicial Balance Sheet for the Federal Gambling Tax*, 53 NW. U. L. REV. 457 (1958). *See also* McKee, *The Fifth Amendment and the Federal Gambling Tax*, 5 DUKE B.J. 86, 88 (1956).

Senator Kefauver is reported to have opposed enactment as futile in this regard unless thirty to forty thousand additional agents were hired—a proposal never seriously considered as relevent to implementation.[101] It is interesting also to note that the Supreme Court, in its opinion upholding the validity of the stamp tax, conceded that the revenue raised is negligible and was constrained further to point out that taxes have been upheld historically even though the intent was to "curtail and hinder, as well as tax. . . ."[102] There appears much merit in Mr. Justice Frankfurter's opinion where he wrote:

> [w]hat is relevent to judgment here is that, even if the history of this legislation as it went through Congress did not give one the libretto to the song, the context of the circumstances which brought forth this enactment—sensationally exploited disclosures regarding gambling in big cities and small, the relation of this gambling to corrupt politics, the impatient public response to these disclosures, the feeling of ineptitude or paralysis on the part of local law-enforcing agencies—emphatically supports what was revealed on the floor of Congress, namely, that what was formally a means of raising revenue for the Federal Government was essentially an effort to check if not to stamp out professional gambling.[103]

What explanation can be given for the Service's failure to follow the Commissioner's own procedures with respect to the administration of these taxes? In the case stated above, the Service first suggested that Revenue Procedure 57-26 applied only in cases initiated by the Audit Division. In so arguing the Service relied on the fact that the Procedure relates to "Procedure in District Audit Divisions."[104] However, the fact that the Procedure so states is hardly remarkable since it is well known that the pre-assessment functions *are* usually performed by the Audit Division. Thus, the reference becomes an acknowledgement of the usual and proper administrative practice rather than a ground for departing from it. To construe the reference otherwise would, of course, permit the conclusion that the intent of the Procedure, as stated in its preamble, can be subverted in any revenue district by the simple device of assigning the audit function to the Collection Division. Such a construction of the language can hardly justify serious support. But there is more that suggests that this argument is groundless. In Revenue Procedure 61-

101. Chenoweth, *supra* note 100, at 458. *See also* King, *The Control of Organized Crime in America*, 4 STAN. L. REV. 52, 59 (1951).
102. United States v. Kahriger, 345 U.S. 22, 27 (1953).
103. *Id.* 38-39 (dissenting opinion).
104. Rev. Proc. 57-26, Sec. 4, 1957-2 CUM. BULL. 1093, 1094.

27[105] the Commissioner deals with 100 percent penalty cases *arising in the District Collection Divisions.* Penalties are, of course, familarly assessed in the Collection Division and it is obvious why the Commissioner separately provided procedures with respect to them. Just as clearly, however, he intended other assessment functions to be handled by the Audit Divisions. Otherwise, the absence of a reference in Revenue Procedure 61-27 to contested *tax assessment* cases would be unexplainable. Finally, even if there is a trace of merit to the proposition that Revenue Procedure 57-26 applies only to audit cases, it would seem inappropriate to apply the procedure when the Collection Division performs the tax audit function.

A second argument offered by the Service in support of its failure to offer the taxpayer the administrative facilities of Revenue Procedure 57-26 was that the Procedure applied only when returns were filed voluntarily by the taxpayer and not to cases where, as here, the tax was assessed on the basis of a so-called "Commissioner's return."[106] However, if one indulges in the assumption—which would not have been by any means unreasonable in this case—that the taxpayer was not indeed subject to the taxes at all,[107] this construction of the applicability of the Revenue Procedure is likewise unconvincing. What ground can there be for treating taxpayer *A* (who agrees he owes some tax but contests the amount proposed by the agent) differently from taxpayer *B* (who denies he is subject to tax at all) in terms of the administrative remedies available to them? The statutory provision authorizing the preparation of a return by the Service has been construed, with regard to income tax assessments, as making no such distinction.[108] Furthermore, the Regulations clearly contemplate the observance of usual deficiency procedures

105. 1961-2 CUM. BULL. 563.

106. INT. REV. CODE of 1954, § 6020.

107. The excise tax on wagers applies not only to the "banker" (who is the owner of the operation) but also to the individual who "writes" the bet (*i.e.,* deals directly with the public). However, if the "writer" registers under the occupational stamp tax *and* discloses the identity of his principal, the writer is exempted from liability for the tax on wagers. There is often, however, also a middle-man called the "pick-up" man whose function is to act as a messenger between the "writer" and the "banker." He is not liable for the tax on wagers *nor* obliged to register and pay the occupational stamp tax. United States v. Calamaro, 354 U.S. 351 (1957); 1957-2 CUM. BULL. 916. Under the circumstances of the cases stated in this Appendix, it was not at all clear whether the taxpayer was a "pick-up" man or a "writer." If he fell in the former category, there would have been no liability for either tax.

Prior to 1958, the "writer" was not liable for the tax on wagers whether or not he had registered under the occupational tax. This may explain why the Service in the example case went back only to 1958 in assessing the taxpayer's liability.

108. See the legislative history of the predecessor of § 6020 quoted in Cantrell & Cochrane Ltd. v. Shea 39-1 USTC ¶ 9388 (S.D.N.Y. 1939). There appears to be no justification to distinguish excise tax cases in this respect.

in these cases.[109] Finally, Revenue Procedure 57-26 itself makes no distinction of the sort.

It should be noted that Revenue Procedure 57-26 supplanted an earlier procedure which, among other things, afforded the taxpayer "every reasonable opportunity *prior to assessment*, for hearing and presentation of the facts and law applicable to their case."[110] There is no reason to suppose Revenue Procedure 57-26 was intended to restrict this opportunity; indeed, the contrary supposition more nearly accords with the facts. Moreover, if Revenue Procedure 57-26 did not entirely preempt the field, I.T. 915 to that extent remained in effect.

So far as the taxpayer is concerned, he, of course, retains the right to sue in the federal district court for a refund of any taxes improperly collected.[111] Why then does the failure of the Service to afford him pre-assessment opportunities for hearing, which are in the first place a matter of the Commissioner's discretion, constitute a matter worthy of question?

To this there are three responses. First, both the Supreme Court[112] and the Commissioner himself[113] have stated that when an administrative procedure *is* established (although the question of its establishment rests in the administrator's discretion), the administrator is obligated to conform to it until it is changed. This point is basic to a system committed to the rule of law. Second, the failure to follow the Revenue Procedure here resulted in attachment of all the taxpayer's assets (in a case where no showing was made of a realistic concern for his inability to pay a liability once properly assessed) causing severe hardship.[114] Third, the failure contributed substantially to the likelihood of an arbitrary and unjustifiable assessment.

But beyond these responses, and basic to the significance of this example to the subject matter of this article, is the reason for this way

109. *See* Treas. Reg. § 301.6020-1(b) (1960).

110. S.T. 915, 1941-1 CUM. BULL. 455 (emphasis added).

111. The Tax Court has no jurisdiction in excise tax cases. If a disagreement is not resolved through administrative process, therefore, the taxpayer's only remedy is to pay the assessment and sue for refund in the federal district court or the Court of Claims. (Rev. Proc. 57-26, Sec. 4.043 1957-2 CUM. BULL. 1093). The importance of the availability of the opportunity for raising objections prior to assessment becomes even greater because of this fact.

112. Vitarelli v. Seaton, 359 U.S. 535 (1959).

113. Rev. Proc. 55-1, 1955-2 CUM. BULL. 897. *Cf.* sec. 3(b) of the Administrative Procedure Act (80 Stat. 250) as amended by Public Law 89-487, 89th Cong., 2d Sess., (1966) which became effective July 4, 1967: ". . . [N]o final order, opinion, statement of policy, interpretation or staff manual or instruction that affects any member of the public may be relied upon, used or cited as precedent by an agency against any private party unless it has been indexed and either made available or published. . . ."

114. Rev. Proc. 57-26, Section 6, specifically excludes jeopardy assessment cases from the pre-assessment procedures it establishes. *See* INT. REV. CODE of 1954, § 6862. The case stated was not a jeopardy assessment case, however.

of doing things. It seems clear that the reason is to be found in the setting of a tax on gambling and in the notion of the tax as a weapon in the battle. There is no reason associated with the requirements of tax adminstration by itself to depart from procedures which are fair to the taxpayer and which, at the same time, protect the revenue. The departure is, rather, attributable to the shift in focus from tax-gathering to the detection and punishment of wrongdoing. The difficulty is, of course, that a governmental apparatus whose function is to gather revenue is structured differently from one directed at detection and punishment of wrongdoers. Furthermore, the variance in structure is not accidental but is directly attributable to this difference in function. The functioning of an administrative apparatus becomes awkward when its mission becomes something other than the one it was designed to accomplish. Frustration and pernicious practice are the results.

INDIANA LAW JOURNAL

Volume 43 WINTER 1968 Number 2

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